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## Global Imbalances and Emerging Markets

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The massive current account imbalance between the United States on the one hand and Asia and Latin America on the other is the most prominent feature of the contemporary international monetary and financial landscape. This pattern is not without its merits. Since the turn of the century, the United States has been the source of the majority of the growth of global demand. It has provided a buoyant market for the exports of the rest of the world. It has facilitated the efforts of countries in Asia and Latin America to accumulate foreign reserves in order to insulate their economies from financial shocks. By enabling the more heavily indebted emerging markets to limit additional borrowing, it has permitted them to pre-fund their external financing needs and lengthen the maturity structure of their obligations. These are not new insights: the idea that the imbalance has benefits not just for the United States but also for the surplus countries is at the heart of the so-called “global co-dependence” and “New Bretton Woods” views of the current global setting (Mann, 2004; Dooley *et al.*, 2003).

The issue is whether these benefits dominate the costs. The current account surpluses and massive reserve accumulation of emerging markets come at the expense of consumption and investment. For Asia excluding China and Japan, investment rates fell by nearly 9 percent of GDP between 1996 and 2004 (see Macfarlane, 2005; Rajan, 2005). In Latin America, the comparable fall was a more modest but still significant 3 percent of GDP. Thus, one alternative to financing the US current account deficit would have been for emerging markets to use

more of their savings to finance additional domestic investment. Whether this would have been advisable depends on one's view of the efficiency of the high levels of investment of the first half of the 1990s, in Asia in particular, and of whether emerging markets are sacrificing growth due to their now lower rates of capital formation.<sup>1</sup> Another option would have been for emerging markets to reduce their saving in favour of higher levels of consumption commensurate with their now higher living standards. Whether this would have been desirable depends on how one interprets those high savings rates, again particularly in Asia, and specifically whether one sees them as an unintended consequence of financial underdevelopment and other domestic distortions or as reflecting the intrinsic preferences of households and firms, in which case there is no obvious rationale for intervening with public policy. One can ask the same questions about public sector behaviour. Are governments wise to pay down debt and accumulate reserves in the effort to bullet proof their economies against external financial disturbances, or would they be better advised to devote additional resources to public investment in education, public health, social security and physical infrastructure? Would these uses of public sector resources be superior to reserve accumulation in light of the costs of sterilisation and the risk of capital losses on dollar balances?

The other question is whether this pattern of global co-dependency could come to grief – in other words, whether global imbalances could unwind in a disorderly and disruptive way – and what the impact would be on emerging markets. More precisely, there are two questions. First, what is the likelihood of a disorderly correction of the US current account deficit? And, second, what would be the impact on emerging markets? While the first of these questions is already the subject of a large literature, the second has received less attention.<sup>2</sup> We therefore make it our focus in this chapter.

We argue that, in contrast to recent crises, the impact on emerging markets of a disorderly correction of global imbalances is likely to flow most immediately through trade rather than financial channels. This resembles the situation prior to recent decades marked by the explosive growth of capital flows; prior to recent decades, trade multipliers and terms of trade effects were the principal avenues through which events

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<sup>1</sup> In more technical language, the question is whether higher investment would have simply been dissipated in a higher incremental capital-output ratio.

<sup>2</sup> Two exceptions are Goldstein (2005) and World Bank (2005a).

in the advanced countries affected the developing world. The same is likely to again be the case today. In turn, this has implications for how emerging markets should prepare for the possibility of the abrupt correction of the US current account and for how they should respond.

## 1 The Likelihood of a Disorderly Correction

There is no consensus regarding the likelihood of a sharp correction of the American current account deficit. One view, epitomised by Roubini and Setser (2005) and Chinn (2005), is that a correction is inevitable because US external indebtedness is on an unsustainable path. The current account deficit is approaching 7 percent of US GDP. Assuming unchanged policies at home and abroad, this deficit balance will continue to widen, approaching 10 percent of GDP at the beginning of the next decade. US net international indebtedness will rise from current levels of roughly 25 percent of GDP to 60 percent in 2010 and more than 100 percent in 2015. In this view, it is simply not plausible that investors in other countries will be willing to accumulate additional claims on the United States at such a rapid rate, or that they will be prepared to hold an ever rising share of their net wealth in the form of US obligations.

The other view is that the US can continue running very substantial deficits if not indefinitely then at least for an extended period. Rapid productivity growth renders the United States an attractive place to invest, sustaining capital inflows (Cooper, 2004).<sup>3</sup> The high savings of other countries have no other logical outlet (Bernanke, 2005). In particular, the inability of other countries to create attractive financial assets at the same pace that they are able to expand their productive capacity, means that as they grow and their residents become wealthier they have a desire to net accumulate claims on the United States (Caballero *et al.*, 2005). Even if the US current account gap still must narrow, this can occur very gradually, say at the rate of half percent of US GDP per year, reducing the rate of growth of US external indebtedness to levels that will be happily absorbed by foreign investors.

Even if private investors reach their limit in terms of their willingness to accumulate additional claims on the United States, there remains the possibility that foreign central banks will continue to provide the necessary finance. Already in 2004-5, foreign central banks,

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<sup>3</sup> See also Clarida (2005) and Backus and Lambert (2005).

and Asian central banks in particular, provided essentially 100 percent of the net financing for the US current account deficit.<sup>4</sup> It is widely argued that foreign central banks are understandably reluctant to change their behaviour abruptly. Were they to curtail the foreign exchange market intervention resulting in their accumulation of reserves and sustaining the ongoing flow of official finance for the US external deficit, their currencies would rise, injuring their export competitiveness and slowing their growth.

Against this is the argument that the appreciation of other currencies against the dollar is inevitable. Sterilising the impact of reserve accumulation on domestic financial markets will become increasingly expensive as entities like the People's Bank of China (PBC) are forced to issue growing quantities of central bank bills.<sup>5</sup> Not sterilising will mean more rapid inflation and real appreciation that is better taken in the form of nominal appreciation that does not damage the credibility of monetary policy. Since central banks are aware of the pressure for the dollar to fall and for other currencies to rise, they have an individual interest in diversifying their reserves out of dollars sooner rather than later, even if they at the same time have a collective interest in continuing to support the greenback.<sup>6</sup>

Our own view (Eichengreen and Park, 2004) is that there will have to be significant adjustment – that neither foreign investors nor foreign central banks will be prepared to continue financing US current account deficits at current levels indefinitely. Our guess, consistent with Obstfeld and Rogoff (2004), is that the US deficit will have to fall to some 3 percent of US GDP – that is, to less than half of current levels – in order to reduce the rate of growth of foreign claims on the US to sustainable levels in the neighbourhood of 60 percent of US GDP.<sup>7</sup> In turn, this will require a further real effective depreciation of the dollar of at least 20 percent. To be sure, exactly how large the fall in the deficit must be, and the size of the associated real depreciation, depends on when the adjustment commences (a point emphasised by Blanchard *et al.*, 2005).

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<sup>4</sup> While private capital flows into the US were large, these were matched by private US foreign investment; this is the sense in which the financing provided by foreign central banks was needed to fully finance the current account deficit.

<sup>5</sup> Garton (2005) provides an estimate of the fiscal costs of reserve accumulation and shows that these already amount to 0.4 to 0.6 percent of GDP for India, South Korea and Malaysia.

<sup>6</sup> See Eichengreen (2004). We return to this argument below.

<sup>7</sup> This is the implication of assuming 5 percent growth of nominal US GDP.

The longer that adjustment is delayed, the larger will be the existing stock of US external liabilities, and the sharper will have to be the increase in net exports in order to service it. In other words, if adjustment begins now, the 20 percent fall in the dollar can plausibly be spread over a period of years. The longer it is delayed, the larger will be the necessary fall in the dollar, and the more likely it becomes that this change in relative prices will be rapid once it begins. And the larger and more rapid the adjustment, the more disruptive will be the effects.

The worst-case scenario is one in which adjustment is delayed until foreign finance dries up abruptly, in turn forcing the US current account deficit to be eliminated at a stroke. The result would then be very sharp compression of US and global demand. In itself this implication is uncontroversial, given the assumption that foreign finance is abruptly curtailed. If capital inflows into the United States decline by 7 percent of GDP because foreign finance dries up, then the current account must move immediately to balance by definition of the balance of payments. The impact effect must be for US demand and specifically the net demand for imports to decline by 7 percent. A 7 percent decline in US demand is a recipe for a decline in global output in the amount of 7 percent of US GDP, other things, including inventory accumulation, being taken as equal. Second-round effects could then aggravate the impact on output and employment.

The mechanism producing these effects is no mystery. A 7 percent decline in net foreign purchases of dollar assets will cause the dollar to fall. It will cause the prices of dollar-denominated assets to decline – equivalently, their yields will rise, eliminating the Greenspan Conundrum. These are two sides of the same coin: a declining dollar and higher US interest rates go together by interest parity. Insofar as a falling dollar implies imported inflation, the Fed will also be forced to raise policy rates faster than expected. These higher interest rates will damp down consumer spending by increasing the cost of consumer credit and limiting the rise in housing prices that has worked to sustain household net wealth in the absence of positive personal saving. They will dampen investment by raising the cost of capital. The fact that US interest rates have recently risen relative to foreign interest rates is at least superficially consistent with the notion that the market attaches a rising probability to this scenario.<sup>8</sup>

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<sup>8</sup> Obstfeld (2005) provides an analysis based on real interest rates backed out from the yields on inflation-indexed bonds.

An objection to this doom-and-gloom picture is that output and employment in the US can be sustained if net imports are reduced by boosting US export sales. This is the implication of the observation that the dollar will depreciate as a result of the shock under consideration here. Demand, rather than falling, can simply be shifted to the rest of the world. But for the rest of the world this would mean a shift in demand away from its own products. The result would be some redistribution of the recessionary impulse from the United States to other countries but no mitigation of the overall recessionary effects. Indeed, to the extent that one is concerned with the implications for emerging markets (as in this book), calling this scenario – in which US output and employment are stabilised by demand rotation – the happy case, is a misnomer.

A further objection, mooted above, is that foreign central banks would never allow financing for the US deficit to be curtailed so abruptly. They recognise that they have an interest in insuring the ongoing flow of external finance for the US current account deficit precisely in order to avoid precipitating a recession. They would step in with further purchases of US assets if private investors pulled the plug. But central banks also have an interest in avoiding capital losses on their dollar reserves. From the point of view of the United States, selling American Treasury and agency securities for German bunds represents a gross capital outflow that would offset the ongoing flow of incremental finance. Individual central banks worry about the impact on domestic monetary conditions and inflation of running large ongoing surpluses. They worry about the resource misallocation that results from keeping interest rates artificially low.<sup>9</sup> They worry about the present or prospective future costs of sterilising the financial effects. They thus have an incentive to diversify out of dollars if they think they can do so without prompting reserve diversification by other central banks and precipitating a move in the dollar. They have an incentive to let their currencies rise if they think they can limit the effects.

To be clear, we are not arguing that the US deficit will necessarily be compressed this sharply. But neither can this possibility be ruled out. In any case, focusing on the worst-case scenario is useful for contemplating the implications for emerging markets.

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<sup>9</sup> Effects that are most clearly evident in China in the form of investment rates that are surely too high to be consistent with allocative efficiency.

## 2 The Impact on Emerging Markets

The World Bank (2005a) provides a catalogue of channels through which a sharp depreciation of the dollar and sudden compression of the US current account deficit will affect emerging markets. To start with positive effects, a declining dollar will reduce the cost of servicing dollar-denominated debt. To some extent, this effect is already evident: between 2002 and 2004 the decline in the dollar reduced ratios of debt to GNP and debt service to exports by one percentage point, reflecting the dominance of dollar-denominated debt.<sup>10</sup> This effect favours relatively heavily indebted countries, where the reduction of debt burdens is particularly valuable, and dollar borrowers, where the exchange rate change works in their favour. In practice, this means mainly Latin American countries like Brazil, Chile and Columbia, where the Bank estimates that the fall in the dollar from 2002 to 2004 reduced the ratio of debt to exports by 4 to 10 percent.<sup>11</sup>

On the negative side, rising US interest rates and declining US Treasury prices could precipitate a flight to quality that heightens volatility in emerging financial markets, with adverse implications for the level and price of capital flows. The curtailment of capital flows toward the United States would make for higher US Treasury benchmarks and wider emerging-market bond spreads, especially for borrowers with high ratios of debt to GDP. The assumption here is that US policy rates are important for the evolution of global interest rates, and emerging market spreads and capital flows co-vary with the level of global rates. Emerging markets also will feel a negative wealth effect from capital losses on their foreign reserves.

This emphasis on the impact on financial markets of a fall in the dollar reflects an effort to shoe-horn this discussion into the financial-crisis paradigm of the 1990s. The immediate way in which emerging markets were affected was by sudden stops in capital flows, in periods when there occurred a flight to quality by investors in advanced countries. This time around, in contrast, the financial consequences are likely to be more ambiguous and less obviously damaging to emerging markets. In fact, the positive correlation between US interest rates and emerging market spreads is less pronounced and less stable than suggested in the World Bank's analysis; for a number of countries and

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<sup>10</sup> World Bank (2005a), p. 52.

<sup>11</sup> To a lesser extent, positive effects are also felt by South Africa and Turkey.

periods this correlation has been essentially non-existent (Eichengreen and Mody, 1998). The response depends on the reason for the rise in US rates and on the reaction of the other advanced countries. If monetary tightening simply reflects the desire to normalise US policy rates, as the Fed seeks to back out the lingering impact of the sharp interest rate reductions taken at the beginning of the decade, then it is plausible that rates in other countries should also rise, as gross financial flows from the US to foreign markets are deterred by rising yields at home. The saving grace here is that interest rates in the financial centres should rise only gradually, as the Fed and other advanced-country central banks weigh the advantages of higher rates for the maintenance of price stability against any negative implications for their economies. And gradual increases in rates should be relatively easy for emerging markets to absorb.

If, on the other hand, the impetus for higher rates in the US stems from sudden evaporation of the willingness of foreign investors to finance the country's current account deficit and from the inflationary effects of the consequent fall in the dollar, then higher interest rates in the US will be accompanied by lower interest rates in the rest of the world. With less liquidity flowing to the US, more liquidity will remain in other markets. Again, this is an implication of the interest parity condition. In other words, in this scenario in which the dollar falls, foreign interest rates must be lower than US rates by the amount of expected foreign currency appreciation in order to satisfy the no-arbitrage condition. And if higher interest rates in the US are accompanied by lower rates in Europe, then it is not obvious that emerging markets will be adversely affected.

For emerging markets to feel a strong negative impact, one must add another element that produces a significant drop in global liquidity. One possibility would be a sharp adjustment of US asset prices that produces distress, or at least fears of distress, among financial institutions, as happened in the bond market correction of 1994 and the LTCM crisis of 1998. Such fears could result in de-leveraging by foreign as well as US financial institutions, reducing global liquidity.

They could produce a global flight to quality and, in particular, less appetite for emerging market debt, as happened in these earlier periods.<sup>12</sup>

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<sup>12</sup> A variation on this theme is how the story was told in the heyday of the Bretton Woods System, when global liquidity was measured as the sum of the US monetary base plus dollar reserves held by foreign central banks. In this model, a

A further problem for narrators of this story is that emerging markets have greatly reduced their dependence on new foreign borrowing. As a group they are running current account surpluses, which means that they have no need for additional foreign debt. In fact, they are reducing net external debt by accumulating reserves. To be sure, if the US current account abruptly moves to balance, current accounts in Asia and Latin America will have to move to balance as well, assuming that Europe's current account balance remains where it is, at zero. This will still mean no additional borrowing. Admittedly, where debt is maturing it will have to be rolled over. But many Latin American and Eastern European countries in this position have pre-funded their re-financing needs while the going is good. Venezuela was already pre-financing debt for 2006 in the middle of 2005; by mid-2005, Mexico had already covered its financing requirements through the end of 2007. Excluding Ecuador, whose external financing needs are considerable, Latin American net financing needs in 2006 is less than 3 percent of exports, down from more than 30 percent in 1996-98.<sup>13</sup> Excluding Turkey, which has a large current account deficit, only half of which is financed by FDI, and large amounts of debt to roll over, Emerging Europe's net financial needs will be less than 7 percent of exports, down from nearly 24 percent in 1996-98.<sup>14</sup> If funding suddenly becomes unavailable, Latin American countries still could retire their maturing obligations and meet their other external financial needs by liquidating just 10 percent of their reserves. The comparable figure for Emerging Europe is 11 percent. Alternatively, closing this gap by increasing net exports would require only

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reduction in the rate of growth of the US monetary base reduced not just US liquidity but also global liquidity, since it meant that foreign central banks were accumulating reserves less quickly. On reflection, it will be evident that this variant of the story requires exchange rates to be pegged to the dollar, for otherwise the monetary base and liquidity in the rest of the world could move independently of dollar reserves. To put it another way, only if currencies are pegged will foreign policies and conditions mimic US policies, as was the case under Bretton Woods; only then will the US be able to act as Stackelberg leader in the global liquidity game. While there is some evidence of this mechanism working in the recent past (see e.g. Jensen, 2005), if foreigners abruptly grow unwilling to finance the US deficit and allow their exchange rates to move, this assumption will be violated.

<sup>13</sup> Ecuador's net financing need is more than 70 percent of exports in 2006, driving up the regional average. Note that all these calculations make assumptions about the continuing flow of FDI and official finance, mainly from the IMF. They assume away the danger of large-scale capital flight.

<sup>14</sup> Including Turkey they will average about 10 percent.

a 1 percent depreciation of Latin American currencies (5 percent including Ecuador) and a 3 percent depreciation of Emerging European currencies (5 percent including Turkey), by Deutsche Bank (2005) estimates.

Given all this, emerging markets would be largely insulated from the financial impact of higher interest rates. The main exceptions would be Ecuador and Turkey and countries with large amounts of interest-rate-indexed debt. This is where some unwinding of emerging market spreads from current, historically unprecedented low levels would bite. In Brazil, for example, domestic debt has an average duration of less than a year and over half is still linked to the overnight interest rate. For a country in this position, a rise in global interest rates could have serious consequences. But recall our earlier scepticism that global rebalancing would mean higher *global* rates.

Curiously, the World Bank's analysis neglects what we would regard as potentially the most important negative channel through which emerging markets will be affected, namely the impact on their trade. The abrupt elimination of foreign financing for the US current account would force the country's net imports to decline by 7 percent of US GDP. This could have serious consequences for emerging markets, even more serious than the impact of higher interest rates.

Since it would take time for dollar depreciation to crowd in additional US exports, we assume that the entire swing comes in the form of US imports. As a first cut, we also assume that the dollar falls by the same amount against all foreign currencies, reducing US imports across the board. (We relax this assumption momentarily.) The impact on other regions then depends on the importance of exports to the US as a share of regional GDP. In data for 2004, this share varies from a high of 23 percent in the small highly open East Asian economies (Hong Kong, Singapore and Taiwan<sup>15</sup>) to a low of 4 percent in the euro area and Japan (see Table 1). In between one finds the Anglo Saxon economies (Australia, Canada, New Zealand and the UK), the larger East Asian economies (Indonesia, Malaysia, the Philippines, South Korea and Thailand) and China toward the high end, at 15, 13 and 15 percent respectively, and Latin America at the low end, at 7 percent.<sup>16</sup>

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<sup>15</sup> We should probably discount the very high figures for these three countries at least to some extent because of the low domestic content of many of their exports.

<sup>16</sup> Oil exporters also rely heavily on the US for their final market, but they are a special case.

**Table 1 Trade by Region, 2004\***  
(percentage of regional GDP)

	United States	Japan	Anglo Saxon	Other Industrial	Large Euro	Small Euro
United States		1.6	4.9	0.4	1.9	1.2
Japan	4.1		1.6	0.3	1.5	1.0
Anglo Saxon	14.5	1.9		1.2	7.0	5.7
Other Industrial	4.6	1.5	4.9		21.5	11.5
Large Euro	3.2	1.0	3.7	3.1		13.3
Small Euro	4.7	1.5	6.9	3.8	27.0	
East Asia 1	13.0	13.2	5.3	0.8	5.1	3.5
East Asia 2	22.5	22.7	14.8	3.4	12.5	7.9
China	14.9	10.2	4.6	0.8	6.5	3.6
Other Emerging Markets	4.9	1.3	3.4	0.9	7.2	4.7
Latin America	7.0	1.3	1.4	0.5	3.8	2.8
Oil-Producers	23.2	2.9	3.7	2.3	5.7	3.7

	East Asia 1	East Asia 2	China	Other Emerging Markets	Latin America	Oil-Producers
United States	1.4	0.9	1.5	0.6	0.6	3.0
Japan	3.7	1.7	3.6	0.4	0.3	1.0
Anglo Saxon	1.6	1.1	1.5	1.2	0.3	1.3
Other Industrial	1.2	1.2	1.4	2.4	0.7	2.9
Large Euro	0.9	0.7	1.4	1.6	0.5	1.2
Small Euro	1.5	1.0	1.7	2.2	0.9	1.7
East Asia 1		10.3	12.3	2.3	1.0	3.2
East Asia 2	42.5		51.7	7.0	1.3	4.2
China	7.7	16.0		1.6	1.3	2.3
Other Emerging Markets	2.0	1.4	2.0		0.6	1.5
Latin America	1.4	0.4	2.4	1.0		2.1
Oil-Producers	2.5	0.8	1.9	1.6	1.4	

*Notes:*

\* The 12 regions are the *US*, *Japan*, *Anglo Saxon* (Australia, Canada, New Zealand, the UK), *Other Industrial* (Denmark, Sweden and Switzerland), *Large Euro* (Italy, France, Germany), *Small Euro* (Austria, Belgium, Finland, Greece, Ireland, the Netherlands, Portugal, Spain), *East Asia 1* (Indonesia, Korea, Malaysia, the Philippines and Thailand), *East Asia 2* (Hong Kong and Singapore), *China*, *Other Emerging Markets* (Egypt, India, Israel, Morocco, Pakistan, South Africa and Turkey), *Latin America* (Argentina, Brazil, Chile, Colombia, Peru), and *Oil-Producers* (Iran, Mexico, Norway, Saudi Arabia, Venezuela).

Source: IMF, Direction of Trade Statistics and International Financial Statistics, Washington D.C.

It flows from this focus on trade that a disorderly correction of the US current account imbalance will have the largest impact on emerging markets most dependent on exports to the US, which means above all the small entrepot economies of Asia. Looking at the issue comparatively, East Asia is more vulnerable than Latin America mainly because the Asian region is more open and not inconsiderably linked to the US.

A more nuanced analysis would allow different currencies to appreciate against the dollar to different extents. For example, one can imagine that Asian countries continue to peg to the dollar at current levels while European countries allow the euro to float upward against it, and that Latin American countries split the difference (they allow their currencies to appreciate against the dollar by half as much as do European countries). In this scenario, Asian currencies depreciate on an effective basis, since they remain unchanged against the dollar but depreciate against the euro and the Latin American currencies. Whether the individual Latin currencies appreciate or depreciate on an effective basis then depends on whether the country issuing them exports mainly to the United States and Asia or to Europe. But looking across emerging-market regions, this scenario will not be happy for Latin America, since it will have to bear more of the global adjustment burden given the absence of an Asian contribution.

Alternatively, one can envisage a scenario in which Asian countries are more inclined than countries in other parts of the world to allow their currencies to appreciate against the dollar, reflecting the relatively robust health of their economies. While Asian currencies then appreciate unambiguously, the magnitude of their effective appreciation will depend on the share of the exports of the issuing country destined for the US.

Truman (2005) has developed several such scenarios. In the first one, the euro rises by 40 percent against the dollar, Asian currencies by 20 percent, and Latin American currencies by 15 percent. In Asia, effective nominal exchange rates remain essentially unchanged, since they appreciate relative to the dollar but depreciate against the euro; this is true for each individual Asian country as well as for the regional aggregate. In Latin America, in contrast, the effective regional exchange rate appreciates (by 6 percent) despite the fact that revaluation against the dollar is smaller. This reflects the fact that more of the region's trade is directed toward the United States. This effect is driven by Mexico and Venezuela, which see their effective rates rise by 9 and 7 percent, respectively. (We may want to disregard the second effect as

reflecting mainly the fact that oil is priced in dollars, something that will not remain the case indefinitely.) Brazil, in contrast, continues to enjoy a 3 percent effective depreciation.

The contrasting scenario is one in which the rise in the euro against the dollar is limited to 20 percent, while the Asian currencies are allowed to appreciate against the dollar by 40 percent and the Latin American currencies continue to rise by 15 percent. Compared to the first scenario, the impact on Mexico is unchanged; the country trades disproportionately with the United States, appreciation of the peso against the dollar is all that matters, and by assumption this remains unchanged. Now, however, Brazil no longer enjoys a nominal depreciation, given the importance of its commodity exports to Asia and the fact that Asian currencies are appreciating.

A more nuanced analysis would also allow a significant slowdown in the US (and a more modest slowdown in China induced by the appreciation of the renminbi) to differentially impact commodity exporting countries. The rapid rate of increase in commodity prices in recent years has reflected strong demand emanating disproportionately from these two countries. Now, if demand slows down in the US and China and therefore global demand slows down, the terms of trade of commodity exporters like Chile and Indonesia will be hit. Conversely, developing countries that depend on commodity imports, which means mainly the resource-poor East Asian countries and, to a lesser degree, Latin American countries like Brazil, will experience weaker commodity prices as a partial cushion against slower global growth.<sup>17</sup> Here petroleum prices, whose pro-cyclical movement is especially strong, given capacity constraints, and their impact on countries like Mexico and Venezuela (along with their countervailing impact on the low-income oil-importing countries of Africa) are simply a particularly pronounced case in point.

In sum, the principal risk to global stability and thus to stability in emerging markets from the current pattern of global imbalances lies in the possibility of a disorderly correction that would precipitate a major slowdown in US growth and a significant rise in US interest rates. But, in contrast to recent experience, the risk to emerging markets does not lie this time in the financial consequences. Emerging markets are running current account surpluses rather than deficits, minimising

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<sup>17</sup> Contrary to popular perception, Brazil with its large and varied manufacturing sector is not a net commodity exporter.

their borrowing. Stronger policies have reduced the danger of capital flight. Prudent debt management has prompted governments to pre-fund their external financial needs. This is not to deny that the exceptionally low level to which emerging market spreads have fallen will not be sustained. But ample international reserves will help countries to compensate for a flight to quality and adverse shifts in the price and direction of international capital flows. Rather, the main risk stems from the possibility of a significant slowdown in US growth and, more specifically, in the growth of US net import demand. The incidence of the effect varies with trade openness and more specifically with dependence on exports to the United States. In Latin America, this means that Mexico is at particular risk. In Asia, exposure to the danger of a disorderly correction is greatest for countries like Singapore, Hong Kong and Taiwan, which are highly open and export heavily to the United States. In addition, the impact will tend to vary with the policy response, not just with the extent to which currencies are allowed to move but with macroeconomic policy generally. It is to this issue that we now turn.

### 3 What Countries Can Do

We now ask what policymakers can do to minimise these risks, starting with the United States and China, the two countries at the centre of this discussion, and then proceeding to Japan, the other Asian countries, and finally Latin America.

#### *The United States*

Of the two ways of gradually reducing the US current account deficit – raising US savings and reducing US investment – the former would be more growth- and employment-friendly. US gross national savings have fallen to 13.6 percent of GDP on the IMF's measure, down by 3.3 percentage points from the 1983-2000 average and barely half the level prevailing in the rest of the world. The problem in the United States is that “everyone talks about the need for a higher savings rate, but no one does anything about it.” This reflects first a paucity of policy tools, and second a lack of political will.

The two obvious tools are monetary and fiscal policies. Higher interest rates would work to limit the rise in asset valuations, and

specifically the rise in housing prices that has reconciled rising household net wealth with zero personal savings. There is a retrospective argument that the Fed should have started sooner and proceeded more quickly with pushing up interest rates back to levels consistent with a positive real rate. The expansion of the US economy has been durable and could have withstood the somewhat faster monetary tightening. Moving real interest rates back into positive territory would have limited the frothiness of asset markets and produced higher personal savings. Authors like Truman (2005) argue that this would have been consistent with Mr. Greenspan's "risk-management strategy" insofar as it would have narrowed the current account deficit and reduced the risk of a disorderly correction. Unfortunately, this critique is retrospective; it is a story about what the Fed should have been doing in 2002-2004. Real interest rates are back in positive territory. Now that the US economy is in the later stages of a cyclical expansion, it is not clear that more monetary tightening would be prudent.

In contrast, the case for fiscal action remains. Since 2001 the US fiscal balance has swung from +2.5 percent to -3.5 percent of GDP. The Congressional Budget Office has attributed changes between earlier fiscal projections and realised outcomes to three sources: discretionary fiscal actions, economic surprises (typically, growth that ran faster or slower than expected), and technical factors (mainly, changes in the level of the stock market that have raised or lowered capital gains revenues).<sup>18</sup> Of the \$750 billion deterioration of the federal budget relative to forecast in the period 2001-2005, more than two-thirds was due to legislative action (the 2001 Bush tax cuts), while the remaining third was due entirely to technical factors (changes in effective tax rates due to changes in capital gains, reflecting the decline in the stock market).<sup>19</sup> This emphasis on revenues is consistent with the observation that federal taxes as a share of GDP have fallen from their historical norm of 22 percent of GDP to 18 percent, while expenditures as a share of GDP have remained largely unchanged. It is consistent with the observation that the big ticket items on the expenditure side going forward are related to health care for the elderly, who are a well-organised lobby in a position to resist cuts.

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<sup>18</sup> See Congressional Budget Office (various issues).

<sup>19</sup> Along with some unexpected costs of increases in entitlement programmes. In contrast, the impact of economic growth on the budget balance was almost exactly as projected.

It follows that the most important thing the US can do to rectify its fiscal imbalance is to allow the Bush tax cuts to expire. Were the tax cuts sunsetted as scheduled (this means, in the main, that cuts on capital gains and dividend income would be allowed to expire at the end of 2008), other discretionary changes in the tax system avoided, and expenditure restraint maintained, the unified budget would return to near balance in 2010, assuming the maintenance of economic growth.<sup>20</sup>

The impact on the balance of payments would be less than proportional. This limited impact on the current account reflects the induced reduction in private savings, corporate savings in particular, as economic growth decelerates. Erceg *et al.* (2005) find that a \$1 billion decline in the US budget deficit produces only a \$200 million improvement in the current account. Using panel data for a group of industrial countries, Chinn and Ito (2005) obtain almost an identical estimate.<sup>21</sup> Such estimates suggest that reducing the budget deficit by 3.5 percent of US GDP would cut the current account deficit by at most 1 percent of GDP. This kind of relatively small overall adjustment in US demand is desirable from the point of view of global growth in order to avoid a recession. In other words, a larger increase in taxes designed to cut the current account deficit still further in the short run is undesirable. This also implies that fiscal consolidation in the United States, by itself, will not obviate the need for depreciation of the dollar and complementary policies abroad.

This scenario also assumes the political will to address the country's fiscal problem. The realism of this is questionable. There is little pressure from the markets to address the budget deficit so long as interest rates on long-term Treasuries remain stable courtesy of purchases by foreign central banks. With the approach later this year of the 2006 mid-term elections and *de facto* commencement of the 2008 presidential campaign, it is not clear that either political party will see it as in its interest to make the case for higher taxes.<sup>22</sup> The war in Iraq, homeland security needs,

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<sup>20</sup> If the tax cuts are allowed to expire, the other costly tax measure for which there is political pressure, reform of the Alternative Minimum Tax, would then become less pressing since more individuals would be subject to the regular tax system and therefore not the ATM.

<sup>21</sup> Gruber and Kamin (2005), in contrast, obtain an even smaller coefficient, reinforcing the point we are about to make.

<sup>22</sup> To the contrary, the House of Representatives in particular shows every inclination to extend the Bush cuts on dividends and capital gains through 2010 and to push through cuts in the Alternative Minimum Tax without including any

Hurricane Katrina, and the recently passed prescription drug benefit all cast doubt on the assumption that expenditure discipline will be maintained. Economists can sound the call for fiscal consolidation, but this does not mean that politicians will hear it.

### *China*

The debate over China's role in the global adjustment process will also be familiar. On the one hand, the country's growth strategy is export led; a substantial appreciation of the renminbi against the dollar that damages export competitiveness could jeopardise this growth and threaten a politically destabilising rise in unemployment. On the other hand, it is hard to envisage that global rebalancing could go smoothly without a contribution from China. If the US current account moves toward smaller deficit, other countries' current accounts must move to smaller surplus. China's surplus is roughly a third the size of the US deficit. This makes it hard to imagine that the entire burden of adjustment could be borne by the countries responsible for the other two thirds: Japan, the Asian NICs, Latin America, and the oil producers.

With Chinese investment rates running at nearly 50 percent of GDP, it is absurd to think that current account adjustment could be effected through still higher investment. Already there are good reasons for questioning the efficiency with which investment capital is being allocated. While not disputing that China needs more industrial capital, modern housing, and urban infrastructure, there are reasons for doubting that it can be deployed even more rapidly. This means that current account adjustment will have to occur through reductions in saving.

Some of this adjustment will come about naturally. As structural change becomes more predictable, households will engage in less precautionary saving. The need to accumulate a financial nest egg will become less pressing as workers worry less about losing jobs in state-owned enterprises, as the state builds pension and health care systems to provide for the elderly, and as the development of credit markets enables households to borrow to defray the costs of tuition, home purchases, and consumer durables.<sup>23</sup> After 2015, the ageing of the

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offsetting tax increases to help pay for the measure.

<sup>23</sup> The importance of financial development for national savings is disputed. Loayza *et al.* (2000) find evidence of a significant negative relationship, while Chinn and Ito (2005) do not.

Chinese population will reduce personal savings, as per the predictions of the life-cycle model. But time will be required for these effects to be felt. None of them will operate on the horizon relevant to global rebalancing.

In the short run – which is the time horizon relevant to the discussion here – the main agent for reducing national saving must be the public sector. Smaller budget deficits in the United States should thus be offset by larger budget deficits in China. The government should begin to gradually increase spending on education, health care, social security, urban infrastructure, and modern housing. A limited increase in public dissaving would move Chinese savings rates in a direction compatible with global rebalancing.

The case for fiscal stimulus in China has been made by Blanchard and Giavazzi (2005). They observe that the country has considerable fiscal room for manoeuvre; even accounting for the implicit fiscal liabilities created by problems in the banking sector, public debt levels remain low. Others, such as Genberg *et al.* (2005), are more cautious. China can only build so many dams, housing projects, and power generating plants in the short run. A further increase in publicly funded construction projects would open the door to the diversion of public funds and bureaucratic inefficiency. To increase social spending, the central government must secure the cooperation of local governments. It is not clear that systematic cooperation to ensure the efficient allocation of public funds can be arranged in short order. And simply throwing money at provincial governments may create additional scope for politically connected lending to state enterprises and others.

Wouldn't further stimulus to domestic demand create risks of inflation and overheating? Here is where there is an argument for currency appreciation. Expansionary fiscal policy in a context where fiscal solvency is not at issue will strengthen the exchange rate. Real appreciation will then slow the growth of exports and prevent overheating and inflation. With the decline in national savings rates, demand will rotate from exports to domestic markets, and orderly appreciation of the exchange rate will work to facilitate this reallocation.

There is a considerable literature debating precisely how much renminbi appreciation is required. Framing the issue as we do here – starting with the need for a reduction in national saving, moving from there to the need for fiscal action, and viewing the adjustment of the exchange rate as an equilibrium response – suggests that the answer is contingent. How much nominal and real exchange rate adjustment is

required will depend on the magnitude of the fiscal initiative and how national saving is affected.<sup>24</sup> It will depend on the evolution of America's growth and current account. A large reduction in Chinese savings that creates significant risks of inflation and overheating will have to be met with a substantial appreciation. A smaller reduction in Chinese savings, which we see as the more likely case, will warrant a smaller real appreciation to avoid precipitating a significant growth slowdown. Similarly, continuing strong demand for imports by the US will help to reconcile a larger renminbi appreciation with the maintenance of Chinese export growth. All this suggests a wait-and-see attitude toward currency appreciation – it suggests letting market forces influence the response.

This wait-and-see attitude is consistent with the rhetoric of the PBC and the Chinese government. It is also consistent with the idea that China will want to deploy a range of policy instruments to protect itself against the disorderly correction of global imbalances. If other investors, public and private, grow reluctant to finance the US deficit, China will not be able to support the dollar by itself. If the dollar falls sharply against other currencies, then the renminbi/dollar rate will have to appreciate in order to contain inflation and avoid overheating. To put it another way, keeping the renminbi pegged to a falling dollar would imply faster monetary expansion in China, which is undesirable. Sharp compression of the US current account deficit, which is what is implied by this scenario, would imply a sharp slowdown in the growth of Chinese exports. In turn, this would render the case for fiscal expansion all the more compelling.

But since China is only a fraction the size of the US, this means that, from the point of view of global demand, fiscal expansion in China can only offset a fraction of fiscal contraction in the US. Even together, then, the US and China only comprise part of the adjustment story.

## *Japan*

Japan is the other East Asian player that has been running large current account surpluses. These reflect the weakness of investment and consumption demand, which are symptoms of the country's decade-long slump. It follows that the most important thing the country can

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<sup>24</sup> In other words, do Chinese households raise their savings in a Ricardian response to expected future taxes, or do they reduce their savings as they observe the development of a social safety net?

do to help resolve the problem of global imbalances and contribute to the general rotation of Asian demand from extra-regional exports to the region itself is to sustain its recovery.

Recent forecasts show Japan finally emerging from its decade-long deflation. Industrial production rose for a fourth month in November 2005. In the same month, consumer prices excluding fresh food (core CPI) rose 0.1 percent from a year earlier – up for the first time in ten years. The Tankan survey published in December showed that confidence among large manufacturers was continuing to climb, suggesting that investment by these producers should exceed earlier expectations. Macroeconomic forecasts suggest that this time, in contrast to other nascent recoveries, the growth of exports (reflecting in part the growth of Chinese demand) should in turn stimulate investment and consumption spending. If this happy scenario is correct, then domestic demand is finally combining with exports to initiate a sustained recovery. The consensus forecast is that the GDP growth rate in 2005 will be about 2½ percent, lower than that in 2004, before falling to 1½ to 2 percent over the next five years.<sup>25</sup>

The country's recovery should be particularly good for economies that export heavily to Japan (first and foremost Indonesia and the Philippines and to a lesser extent China, Korea, Malaysia, Thailand and Vietnam) and for countries whose export structure closely matches the composition of Japanese import demand (China, Korea, Malaysia, Singapore, Taiwan and Thailand).<sup>26</sup> In other words, Japanese recovery would be helpful for almost everyone in the region. Moreover, as Japan's recovery gains strength, there is likely to be a tendency for the yen to appreciate (Huang, 2006), which will make it easier for other governments in the region to contemplate appreciation of their currencies against the dollar.

National savings are expected to remain at around 25 percent of GDP. Household savings had slid to a little over 6 percent of GDP before turning up again in 2002. With the recovery gathering strength, Japanese households should now start saving more. As in other East Asian economies including China, Korea, and Taiwan, the business sector has been generating large surpluses, which are likely to continue at current levels

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<sup>25</sup> However, recent developments lead one to believe that these forecasts are on the low side; there is little doubt that for the first time in ten years Japan's motor of domestic demand has begun humming.

<sup>26</sup> Japan absorbs more than 20 percent of the exports of the first two countries and more than 10 percent of the exports of the others. The calculations of the similarity of domestic industries with Japanese imports are from Huang (2006).

or decline slightly. Current account developments will therefore hinge on investment spending. Consensus forecasts (e.g. Daiwa 2005) point to a slow but steady increase in the aggregate investment rate. As a result, there will be modest pressure for the yen to appreciate, and the current account surplus for 2006 should decline slightly to 3 percent of GDP.

Can Japan do more? At this stage few would argue for an activist macroeconomic policy or, in particular, for more government spending on infrastructure and other public projects. Gross national debt is approaching 150 percent of GDP, and population ageing will make management of this burden more difficult going forward. The authorities are committed to eliminating the existing budget deficit as quickly as possible.

Signs that deflation is ending have opened a debate over whether the Bank of Japan should end its super easy monetary policy, which has driven the real interest rate below zero. The restoration of positive real interest rates will enhance the efficiency of credit-allocation mechanisms and force more normal behaviour on the banking system. The central bank is evidently anxious to move in this direction.

Given the moderate pace of recovery, however, there is the concern that any increase in the interest rate intended to restore the normalcy of monetary policy could choke off growth and plunge the economy back into recession. Higher interest rates would slow investment demand and thereby further limit Japan's contribution to global rebalancing.

In sum, the most important contribution Japan can make to the resolution of global imbalances is to sustain its still fragile recovery. In the present context, this means not repeating the mistakes of the past by tightening monetary policy prematurely and adjusting fiscal policy too sharply.

### ***Emerging East Asia Excluding China***

East Asian countries have traditionally valued fiscal prudence. Reflecting this fiscal conservatism, government debt as a share of GDP has been low in East Asia except for Japan and the Philippines (Table 2). Many young democracies in East Asia find it difficult to adjust fiscal policy as a result of a slow and complicated political process of determining the size and distribution of government expenditure between projects, sectors, and regions. Fiscal policy can even be pro-cyclical if that lag is very long. East Asian policymakers are also cautious to avoid replicating Japan's experience with a pump-priming policy that has resulted mostly in a massive increase in national debt.

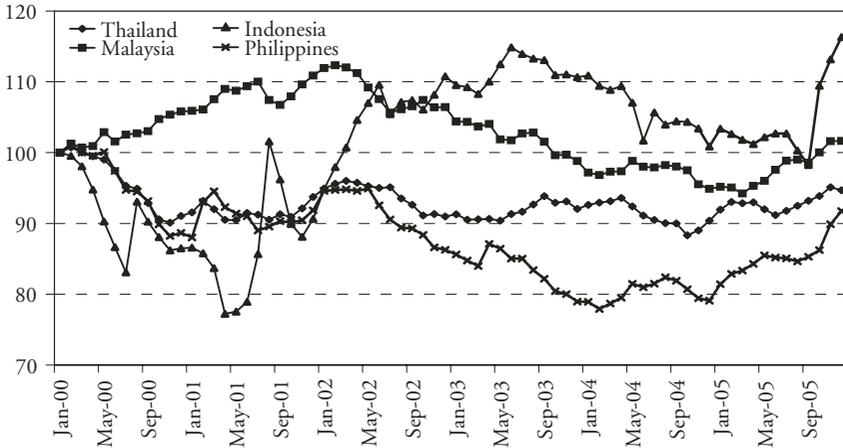
**Table 2 Selected Fiscal Indicators**  
(percentage of GDP)

	<i>General Government Gross Debt</i>					
	2000	2001	2002	2003	2004 Est.	2005 Proj.
Japan	139.3	148.8	158.4	164.7	169.2	174.4
China	16.9	18.7	20.6	21.3	20.0	19.1
Hong Kong	..	..	..	..	..	..
South Korea	29.2	33.8	32.4	32.6	33.6	32.9
Singapore	..	..	..	..	..	..
Taiwan	24.4	31.5	35.1	37.6	39.6	41.5
Indonesia	91.3	78.2	69.2	60.2	57.9	53.3
Malaysia	36.7	43.6	45.6	47.1	46.0	44.8
Philippines	89.1	88.4	93.8	101.3	99.6	97.0
Thailand	23.0	24.8	31.3	28.5	28.6	26.2
	<i>Central Governmental Fiscal Balance</i>					
Japan	-6.9	-6.3	-6.9	-7.1	-7.0	-6.9
China	-3.6	-3.1	-3.3	-2.8	-1.7	-1.7
Hong Kong	-0.6	-5.0	-4.9	-3.2	-0.8	-0.7
South Korea	1.1	0.6	2.3	2.7	2.3	2.2
Singapore	7.9	4.8	4.0	5.8	3.9	4.5
Taiwan	-0.5	-2.8	-4.3	-4.0	-3.3	-3.0
Indonesia	-3.4	-3.2	-1.5	-1.9	-1.4	-1.6
Malaysia	-5.7	-5.5	-5.6	-5.3	-4.3	-3.5
Philippines	-4.6	-4.6	-5.6	-5.0	-4.2	-3.9
Thailand	-2.0	-2.1	-2.3	0.4	0.3	0.5

Source: IMF, *Regional Outlook September 2005*, Asia and Pacific Department, International Monetary Fund, Washington D.C., 2005.

Among the ASEAN states, Indonesia and the Philippines are in no position to contemplate further increases in government spending or cut taxes. The Indonesian government is committed to further fiscal consolidation to reduce vulnerability arising from the high level of public debt. Its objective is to achieve broad budgetary balance by 2006-2007 consistent with lowering public debt to no more than 50 percent of GDP. The Indonesian government has also been engaged in fiscal reform that envisages more efficient tax administration and improvement in budget preparation and execution. Public debt in the Philippines is close to 100 percent of GDP, which is high and unsustainable. The government has committed itself to balancing the budget by 2009 by tax increases and streamlining fiscal expenditure.

**Figure 1 Real Effective Exchange Rate in ASEAN-4**  
(January 2000=100)



Source: Bank for International Settlements.

Thailand and Malaysia have been more successful at bringing their budget deficits down to manageable levels. As a result, Thailand now has a room for additional fiscal stimulus, and its authorities have seen the need to run a budgetary deficit to boost domestic demand. South Korea, Singapore and Taiwan could certainly apply significant doses of fiscal expansion. Of these countries, South Korea has been most active in implementing an expenditure switching policy by combining an increase in government spending with an exchange rate appreciation. The other two countries have not been as active as export earnings have been large enough to sustain relatively high rates of growth.

There is little disagreement that an across the board appreciation of East Asian currencies constitutes an important component of the resolution of global imbalances. However, if China insists on maintaining its limited flexibility, other East Asian countries are not likely to let their currencies appreciate vis-à-vis the renminbi as China has emerged as their export competitor in regional as well as global markets. This creates a problem of collective action and an argument for policy coordination.

China's tentative move to a basket peg and a more flexible exchange rate on July 21, 2005 is significant in this light. Kawai (2002) argues that South Korea and Thailand have also shifted to *de facto* basket arrangements similar to Singapore's managed float. Prompted by China's decision, Malaysia has now also adopted a basket arrangement and a

more flexible rate. The behaviour of real effective exchange rates of Indonesia and the Philippines (Figure 1) suggests that their currencies are also now linked to a basket. Aside from the yen, which will continue to float independently, practically all emerging economies in East Asia now have a similar framework of exchange rate policy, which ought to facilitate coordinated action.

But it is a problem that one important country, Japan, does not wish to participate in a regional framework for exchange rate coordination. This is because the yen is a free floating international currency, whereas other East Asian currencies are non-convertible (except for the Singapore dollar) and linked to baskets of regional and international currencies. Japan has a relatively small external sector, making it less sensitive to currency fluctuations. All this suggests that the principal ASEAN economies, together with China, Korea and Hong Kong, will have to work out agreement to coordinate exchange rate adjustments among themselves.

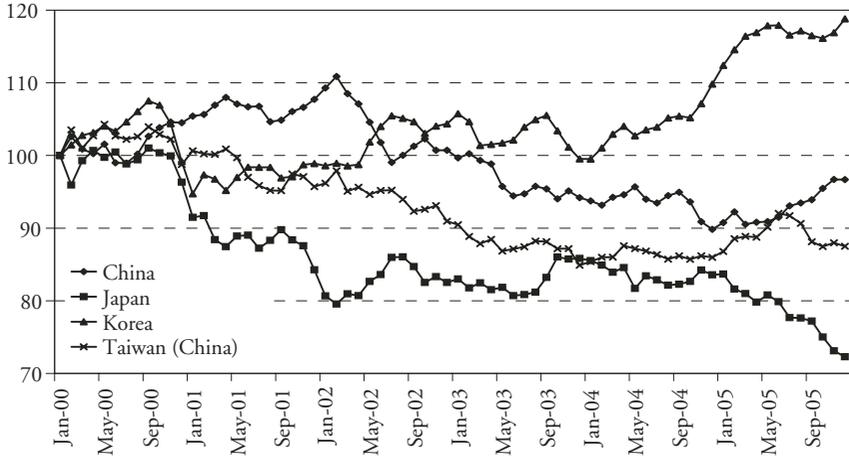
Another complication is related to differences in bilateral trade imbalances among the East Asian countries themselves. When the ten East Asian countries are divided into Japan, China, and the other emerging economies, Japan has been running surpluses in its trade with all these economies including China.<sup>27</sup> The group of emerging economies on the other hand has been running a surplus in its trade with China but a large deficit with Japan.

Because of these different profiles of the bilateral imbalances, the group of East Asian emerging economies may be able to accept a simultaneous appreciation of their currencies and the renminbi against the US dollar. However, if the yen is not expected to appreciate, China and other emerging economies will not go along with the joint appreciation, for fear of deepening their persistent structural trade deficits with Japan. And the yen will not necessarily appreciate vis-à-vis the US dollar unless the Japanese authorities intervene, which they have not shown an inclination of doing recently. To economists, bilateral trade imbalances may not matter, but to East Asian politicians and policymakers they can matter a lot, especially when the source of deficits is Japan. This dilemma underscores the need to bring Japan

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<sup>27</sup> According to Chinese trade statistics, China is in deficit vis-à-vis Japan. Japanese statistics, however, show that Japan is running a deficit in its trade with China. The difference stems from the inclusion of Hong Kong as part of China in the Japanese statistics.

**Figure 2 Real Effective Exchange Rate in Other Asian Countries**  
(January 2000=100)



Source: Bank for International Settlements.

into a regional arrangement for exchange rate policy cooperation. Success would require overcoming the problem that China and Japan do not see eye to eye on many issues, largely because of their rivalry for economic and political influence in East Asia.

A recent IMF report describes the decline in reserve accumulation in East Asia in 2005 as having been dramatic (IMF, 2005b). Is this a promising sign that East Asia's imbalance vis-à-vis the rest of the world is resolving itself into a manageable magnitude through market forces and no longer poses threat to global financial stability?

Not obviously. If the region's terms of trade improve as the recent upsurge in crude oil prices is tempered and the US trade deficit continues to increase East Asia may start registering a larger surplus on current account again. As growth picks up in the region on the back of Japan's recovery, some of East Asia's emerging economies may experience a renewed surge in capital inflows, as they did in 2003 and 2004.

To counter these developments, some countries like Thailand have undertaken or are planning to initiate large public investment projects, while others have loosened up capital controls to facilitate capital outflows. Eight years after the outbreak of the financial crisis in 1997-98, East Asia's emerging economies excluding China appear to have eliminated much of the excess capacity they built during the boom years of the early 1990s and hence will resume their capital spending (Lee, 2006). As shown in Figure 2, this has created a tendency for the Korean won

and the currencies of the ASEAN-4 to appreciate in real effective terms. Given this, the contribution of Korea and the ASEAN-4 to the trans-Pacific imbalance seems likely to shrink. But not so Japan and China's current account balances, which will remain at 3 and 4 percent of GDP for the foreseeable future. This means that the trans-Pacific imbalance between East Asia as a whole and the US will be transformed into largely an imbalance between Japan and China on the one hand and the US on the other. And, in turn, this means that leadership in resolving it will have to come from these two countries.

### *Latin America*

Latin American countries are in a particularly difficult position insofar as they export heavily to the United States. They have little scope for a monetary or fiscal response. In countries like Mexico, Brazil and Chile, the central bank targets inflation and increasingly allows the exchange rate to fluctuate as needed to achieve this end.<sup>28</sup> Mexico, Brazil and Chile cannot simply follow the dollar down, since this would jeopardise hard-won anti-inflationary credibility. Only in Chile is there arguably room for the active use of fiscal policy.

A reduction in real interest rates from their current high levels, most notably in Brazil, would provide useful economic stimulus.<sup>29</sup> But this is tantamount to assuming a solution to the problem. In particular, it assumes a reduction in political noise, the maintenance of fiscal discipline, and further steps at strengthening institutions of contract enforcement precisely when a less favourable global economic environment would make ongoing reforms more difficult to sustain.<sup>30</sup>

The macroeconomic impact of a reduction in real interest rates would presumably be felt in the form of higher rates of investment; in

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<sup>28</sup> Only in Argentina is priority attached to *de facto* dollar pegging. Dollarised economies like Ecuador and El Salvador of course fall into this category as well.

<sup>29</sup> In Brazil, the real interest rate on long-term inflation-indexed bonds remains well in excess of 8 percent, extraordinary levels by international standards.

<sup>30</sup> Latin American governments have also sought to encourage savings and investment by transforming pensions from pay-as-you-go systems to privately capitalised individual retirement accounts where this has not already occurred, as in Brazil, authors like Dayal-Gulati and Thimann (1997) having shown that such reforms have a significant impact on savings rates. But it takes time for these reforms to show up in changes in national savings rates – too much time for the measure to be relevant to the resolution of global imbalances.

Latin America, where savings and investment rates are less than half of Chinese levels, there is a strong case for adjusting current accounts by raising investment rather than reducing saving. The region's relatively low levels of investment reflect a long history of policy instability, income inequality, and weak creditor rights.<sup>31</sup> Although progress in solving these problems is underway, profound changes in the social and economic fabric are not knit overnight. That is to say, they are unlikely to be completed on the time frame relevant to offsetting the impact on the region of a disorderly correction of global imbalances.

#### 4 Conclusion

Observers from emerging markets have long complained that discussions of the problem of economic crises have exaggerated weaknesses in policies and institutions in the developing world while neglecting the influence of the advanced industrial countries and global financial markets. This may or may not be a valid critique of accounts of crises past, but there is no question that the US current account deficit and its implications for global adjustment now constitute the main risk to financial stability going forward. With few exceptions, emerging markets have gone a long way in reducing their vulnerability, shifting from current account deficit to surplus, pre-funding their external financing needs, building up reserves, strengthening their fiscal positions, and buttressing price stability. US policymakers have meanwhile moved in the opposite direction by allowing an unsustainable external imbalance to emerge.

Although emerging markets have done much to strengthen their financial position, they now face the urgent task of preparing themselves for the eventual unwinding of the US deficit. Avoiding a significant slowdown in economic growth will require them to shift the composition of demand from external to internal sources. In turn, this will require a shift in the policy mix toward tighter monetary and looser fiscal policies. Exchange rates against the dollar will have to adjust. Not all emerging markets are in an equally good position to undertake these adjustments. Some countries have limited fiscal room for manoeuvre. Others are

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<sup>31</sup> In addition, insofar high savings and growth rates go together (Gavin *et al.*, 1997; Eichengreen, 2005), Latin America may be in a low saving, low growth equilibrium from which it is difficult to break out quickly.

jittery about letting their currencies appreciate against the dollar. Commencing this adjustment process while global economic and financial conditions are still favourable will ease the adjustment process. So too will cooperation on exchange rate and other policies. It would be nice if the United States would participate in this process of cooperative policy adjustment by addressing the domestic roots of its twin deficits. But emerging markets cannot afford to wait for the US to act.

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